Introduction to Real Estate

Chapter 4: Evaluations (Appraisals)

Standard: **Develop an understanding of the steps in the appraisal process.**
(CIP #08.1701-0401)

Objectives:

- Identify the six steps in the appraisal process.
- Differentiate between the three appraisal report formats.
- Identify the four items essential to all appraisals.
- Explain the different forms of depreciation.
- Determine the approach best suited to the appraisal of different types of property.

Appraisal Process

Information: An appraisal is best defined as an estimate, or opinion, of value of an adequately described property, as of a specific date, by a competent appraiser, supported by factual and relevant data. The valuation or appraisal of real estate is utilized in all phases of the real estate business an in almost every real estate transaction. Although a real estate agent does not need to qualify as an appraiser, it is important that an agent has an understanding of the appraisal process in order to assist buyers or sellers in determining the value of property. An official appraisal can only be issued by an individual certified to do so. Lending institutions will usually require an appraisal, as well as government agencies for establishing a basis for taxation.

Identify the 6 Steps in the Appraisal Process

The appraisal process typically consists of the following six steps:

1. **Define the problem.** This involves establishing at the beginning, exactly what is to be appraised, the purpose of the appraisal, and the date of the appraisal.

2. **Conduct the survey.** Determine the personnel *(not personal)* needs, fee, and general information about the property. This involves inspecting the neighborhood and the subject property. The appraiser will also consider the age and physical condition of typical properties; the convenience of the subject property to churches, schools, transportation, and shopping; the apparent rate and direction of growth; vacancies, zoning, and trends towards other uses; and any favorable or unfavorable characteristics which might affect the value of the subject property.

3. **Gather data.** Some of the data will be gathered during an inspection of the property and neighborhood and the rest will be relevant factual data about the region, city, or neighborhood. Together they will form the foundation of the appraisal.

4. **Classify data.** Separate by market data (Market Data Approach), cost/replacement value (Cost Approach), or its income-producing history or potential (Income Approach).

5. **Reconcile data.** Reconcile the data gathered from the three approaches to determine a final estimate of value. Usually, only one set of classified date (ie. the Market Data Approach), will be all that is necessary to estimate the value of a piece of real estate. The appraiser's conclusion of the value of the property must be supported and documented by data gathered.

6. **Issue the report.** The written report can be in any one of three formats, depending on the needs of the person or institution requesting the report.

Three Appraisal Report Formats

There are two types of "scopes," **Complete Scope** and **Limited Scope**. Each of these scopes can be reported in one of the following three formats:

(A) The **Restricted** form is quick and easy. It is used by a buyer or seller who doesn't want to pay much for the report and is only looking for a simple statement of value. Though the report is relatively simple, the gathering of the information and the accuracy of the conclusion should be the same as it would be for other report forms.

(B) The **Summary** is used primarily by institutional lenders. They are often just the front and back of a single legal sized sheet of paper, but the information required is quite comprehensive.

(C) The **Narrative Report** provides an estimate of value and then gives everything reasonable to justify their findings. It includes photographs, maps, inventories, personnel records, as well as comparables, income information, and computations. It is used most often for commercial/industrial appraisals, court cases, and by out-of-town buyers.

Four Items Essential to All Appraisals.

1. **Date.** The appraiser only takes responsibility for the value of the property they appraise for the day the report is dated. The lender will usually accept the appraised value for the following six months in order to process loans.

2. **Property description.** It is important that everyone agrees that the property description identifies the exact property involved in the appraisal.

3. **Estimate of value.** The appraiser is responsible to give a professional estimate of value, not a guess. Decisions will be made on the basis of the appraiser's valuation. If the information is not reasonably accurate, the appraiser could be liable and be sued.

4. **Signature of the appraiser.** The signature verifies that the appraiser accepts the liability and that the estimate is a "professional estimate of market value that can be relied on for decision-making.

The Different Forms of Depreciation

An appraiser will frequently have to calculate depreciation—a loss in value to the improvements of a property due to any cause—in determining value of a piece of property. Depreciation is broken down into three distinct areas:

1. **Deterioration.** Physical deterioration is most commonly evidenced as ordinary wear and tear on improvements.

2. **Functional obsolescence.** This may be defined as the lack of desirability due to functional shortcomings such as size, style, age, etc., particularly when they are compared with those existing in new, more modern and efficient structures serving the same function.

3. **Economic obsolescence.** A loss in value that is caused by changes that are external, or outside the subject property, such as a residence in close proximity to a new high speed highway or industrial complex, or to a new airport which has its approach path over a residential area. Another example would be building downwind from a slaughterhouse.

Curable and Incurable Depreciation
After separating depreciation into these three types, each type may be further broken down as to being: (a) curable; or (b) incurable.

- **Curable.** That depreciation which can be economically repaired, replaced, or corrected. Examples would be a worn out roof, old style kitchen or fixtures, etc.

- **Incurable.** That depreciation in which it is not economically feasible or profitable to replace or cure the condition. Economic obsolescence, for example, is incurable.

3 Different Approaches to Determine Value

Three commonly accepted approaches to value: (1) the cost approach; (2) the market data approach (a.k.a. the comparison approach); and (3) the income approach (a.k.a. the capitalization approach).

1. **Cost Approach.** The cost approach consists of four basic steps
   (A) Estimate of value of the land as if it were vacant.
   (B) Estimate of current cost of replacing or reproducing the building.
   (C) Estimate and deduct the amount of depreciation.
   (D) Add the estimated land value to the depreciated reproduction or replacement cost of the building to arrive at an indication of the total value of the property.

2. **Market Data Approach.** Value estimates by this approach are most commonly used by real estate brokers and salesmen in their everyday estimation of market values. The market data approach is based on the principle of substitution, by which the price of a property will not generally exceed the cost necessary to acquire a similar substitute property of equal desirability which is readily available on the open market. The comparative sale must have taken place within a reasonably recent period of time (such as three months), and have been a bona fide transaction by parties not forced to buy or sell. When the comparable

property contains features which are dissimilar to the subject property, the appraiser must adjust the sales price of the comparable property to the subject property in order to compensate for these differences.

3. **Income Approach.** The income approach is an evaluation of a projected income stream, and is based on the assumption that the value of a property may be determined by the net income it can reasonably produce over its remaining economic life (the period over which a property may be profitably utilized). Thus, the value of an income producing property is equal to the present worth of a future income. Stated another way, an income producing property is worth what someone will pay for it in order to have the right to receive the income. This is called capitalizing the income stream.

There are four basic steps used to determine value using the income approach. These are:

(1) **Estimate potential gross income.** Gross income refers to the total annual income the property would likely produce if it were fully occupied, or its potential income from all sources.

(2) **Estimate effective gross income.** Potential gross income less an allowance for vacancy and bad debts is termed effective gross income.

(3) **Deduct annual expenses to arrive at net income.** These are expenses chargeable to the operation of the property, which may be (a) fixed expenses, which are those that remain the same whether the units are rented or not, such as property taxes, insurance, etc.; (b) operating expenses, which cover janitorial services, grounds care, etc.; and (c) reserves for replacements, which constitutes the annual allowance for replacement of equipment and building components such as stoves, refrigerators, air conditioners, carpets, drapes, water heaters, etc.

(4) **Capitalize the net income.** The **capitalization rate** is the rate of yield or return that the investor expects on the purchase price, and thus, the value may be determined by dividing the net income by the capitalization rate.

Determine Best Appraisal Approach

Based on the information above, what appraisal approach would be best suited to each? 1. an apartment complex; 2. a building in an industrial complex; 3. a new house in a rural setting; 4. a condominium. Can you explain your choices?

Introduction to Real Estate

Chapter 4: Evaluations (Appraisals)

Standard: **Determine the requirements necessary to become an appraiser.**
(CIP #08.1701-0402)

Objectives:

- Determine the need for real estate appraisers.
- Identify the requirements for the different appraisal designations.
- Understand appraising regulations and their application to real estate agents.
- Define appraisal terms.

Appraisal as a Career

Information: As the housing demand in the United States continues to grow at a rapid rate, so does the need for all support services. The real estate appraiser is a critical link in the survival of the housing industry.

The Need for Real Estate Appraisers

In many areas experiencing growth, it is almost impossible for them to keep up with the demands of the market. In some areas there is a wait of up to three months for an appraisal, holding up the closing of loans. It is an occupation that should continue to see healthy growth for some time.

An individual choosing appraisal as a career must undergo extensive training. As mentioned earlier in the text, there are some vital decisions that must be made based on the opinion of an appraiser, and the liability for poorly done work can be high. An appraisal is not something that can be done easily in a day. There is a great deal of research involved, calculations, decision-making, investigation, and paper work involved, sometimes taking several days. It is a career that can be rewarding—both personally and financially—for the person who is willing to put forth the effort and who enjoys working under these conditions.

Utah's Requirements for the Different Appraisal Designations

Most states, Utah included, require that all real estate appraisers be either **Licensed** or **Certified.** The following are the categories of appraiser designations:

Level 1: Apprenticeship to Certified Appraiser. This requires that a person who wants to become an appraiser must be affiliated or employed by a Certified Appraiser. He or she will begin the steps of learning the appraisal industry, working under the guidance of a Certified appraiser. Most apprentices have already completed the real estate appraisal education and passed the state exam required to be a Level 2—Licensed Appraiser.

Level 2: Licensed Appraiser. This classification is authorized to appraise all types of residential real estate up to $250,000 and real property up to 2 units, but may not issue a "certified" appraisal report. The Certified appraiser is responsible for validating and checking all work and signing-off on the appraisal. To become a Licensed appraiser, the candidate must:

1. Complete **90 hours** of real estate appraisal education, including 15 hours of Standard of Professional Appraisal Practice.

2. Pass a state examination.

3. Accumulate 2000 hours during a minimum of 24 months—equivalent to **400 points** (*General rule of thumb:* 1 appraisal = 1 point)

Level 3: Certified Residential Appraiser. This classification may appraise all real estate not requiring a discounted cash flow analysis and residential real estate of up to twelve units when a net income capitalization analysis is not required. They can provide a "certified" appraisal report. The requirements to become a Certified Residential Appraiser are:

1. Complete an additional 30 hours (for a total of **120 hours**) of real estate appraisal education, including 15 hours of Standards of Professional Appraisal Practice.

2. Send a random sampling of completed appraisals to the Department of Commerce—Real Estate Division. An Appraisal Board will review appraisals to determine if candidate is up to standards.

3. Pass a 2nd Level state examination.

4. Accumulate an additional 100 points (a total of **500 points**) during a minimum of 30 months (Equivalent to 2500 hours).

Level 4: Certified General Appraiser. This classification may appraise all types of real estate, including complex commercial properties, and provide a "certified" appraisal report. The requirements to become a Certified General Appraiser are:

1. Complete an additional 60 hours (a total of **180 hours**) of real estate appraisal education, including 15 hours of Standards of Professional Appraisal Practice.

2. Pass a 3rd Level state examination.

3. Accumulate an additional 100 points (a total of **600 points**) during a minimum of 36 months (Equivalent to 3000 hours). A certain number of appraisals must be commercial properties. *The point system changes at this level since it takes approximately 2 weeks to complete a commercial appraisal. Points for commercial property are based on size and complexity of project.*

Real Estate Agents Cannot Perform Appraisals

The above regulations do not apply to real estate licensees who, in the ordinary course of business, give an "opinion" as to the recommended listing price of real estate or an opinion as to the recommended purchase price of real estate. However, such an opinion as to the listing price or the purchase price may not be referred to as an appraisal. Referring to a market analysis as an appraisal by an unauthorized real estate agent could result in fines, lawsuits, and the loss of their real estate license.

REAL ESTATE APPRAISAL—TERMINOLOGY

Accrued Depreciation. Total depreciation, both curable and incurable, affecting the value of a property at a given time.

Action of the Sun. The south and west sides of the street and the southwest corner are best for retail business because of shade from the sun.

Adjusted Gross. The adjustment of the gross income by deducting a percentage for vacancies.

Appraisal. Computing the value of a property. An estimate value; an opinion resulting from an analysis of the facts.

Blighted Area. An area in which values are declining, because of these destructive economic forces: lower economic class, inharmonious usage, rapidly depreciating buildings.

Capitalization Rate. A Percentage return that an investor requires on his investment, the same as a lender requires a percentage return on his loan.

Corner Influence. Value is affected by location at an intersection.

Curable Depreciation. The factors of depreciation that can be corrected for a reasonable cost. Incurable depreciation cannot be corrected without excessive cost.

Deferred Maintenance. The cost to correct conditions caused by neglect that were not maintained by reasonable care.

Depreciation. Loss of value from any cause, such as: age, physical deterioration, functional or economic obsolescence.

Deterioration. Loss of value from wear and tear. Physical deterioration.

Directional Growth. The direction in which the residential sections of a city are destined to grow.

Economic Life. The period of time during which a property will yield a return on an investment, exclusive of the land. It is always shorter than the physical life.

Economic Obsolescence. Depreciation caused from factors which are outside the property lines, such as bad zoning. Also called Social Obsolescence.

Functional Obsolescence. Depreciation caused from factors which are inside the property lines, such as old fashioned fixtures or outmoded architectural design.

Highest and Best Use. The first principle an appraiser should consider—the use which is most likely to produce the greatest net return over a selected period of years.

Leverage. Using your credit to buy property and make a profit.

Market Value. The price a willing buyer would pay to a willing seller, providing the property was exposed for a reasonable period of time.

Net Income. The income remaining after deducting the allowable expenses from the gross income of an income-producing property.

Livable Floor Space. Inside dimensions of rooms, halls, and closets.

Orientation. Placing a structure on its lot by taking into consideration it' exposure to the elements, such as sun, wind, and the noise of traffic.

Principal of Change. The law of cause and effect. Reconstruction, rezoning, directional growth are just a few factors that effect this principal.

Value. The price paid for the property.

PRACTICAL APPLICATIONS

1. Invite a real estate appraiser to come in to the class to discuss appraising as a career; the pros and cons of the business; income expectations; and the future of the industry.

2. Do you have what it takes to be a real estate appraiser? If a guest speaker comes into the class, write an evaluation of yourself as a potential candidate for the real estate appraisal field. If a speaker does not come, contact an appraiser in your community and ask them about the requirements (besides education), etc. of the business. Prepare a written evaluation.

3. Apply the comparable appraisal process to understand value. You may use the activity provided or create your own appraisal by locating a piece of property that is for sale in your community. Gather the date necessary to put together an appraisal report. Prepare the appraisal, including all the necessary information, including pictures of the subject property, and at least two comparable properties.